CHAPTER 6

CORPORATE TAX RATES

The Treasury Department proposals would define the corporate tax base more accurately and comprehensively. The corporate income tax rate could thus be reduced to 33 percent. Moreover, the corporate minimum tax and the personal holding company tax could be repealed.

REDUCE CORPORATE INCOME TAX RATES

General Explanation

Chapter 6.01

Current Law

In general, a tax is imposed on the taxable income of corporations at a maximum rate of 46 percent for all such income in excess of $100,000. For corporate income under $100,000, tax generally is imposed under the following schedule:

(1) 15 percent of so much of the taxable income as does not exceed $25,000;

(2) 18 percent of so much of the taxable income as exceeds $25,000 but does not exceed $50,000;

(3) 30 percent of so much of the taxable income as exceeds $50,000 but does not exceed $75,000; and

(4) 40 percent of so much of the taxable income as exceeds $75,000 but does not exceed $100,000.

The graduated rates are phased out for corporations with taxable income over $1,000,000, so that corporations with taxable income of $1,405,000 or more pay, in effect, a flat tax at the 46 percent rate.

Reasons for Change

The current corporate income tax structure overtaxes some corporations and undertaxes others. Although corporations generally are subject to a uniform rate structure, the base of income subject to tax differs depending on the extent to which corporations are able to generate preferred sources of income or deductions. For corporations with overstated deductions or losses, or deferred or exempt income, the effective rate of tax may be far below the prescribed statutory rate. By broadening the base of corporate income, corporate tax rates can be reduced and made applicable on a more nearly uniform basis.

In addition, the current progressive rate structure for corporate income serves no affirmative purpose and encourages the use of corporations to gain the advantage of low marginal tax rates. The progressive rate structure for individuals is premised on the ability-to-pay concept, which in turn reflects an assumption that additional amounts of income are increasingly available for discretionary, nonessential consumption. These concepts have no relevance to corporate income, all of which is either distributed or used to produce additional income. Moreover, under current law a small corporation can escape high marginal tax rates on corporate income by electing pass-through treatment as an S corporation.

Finally, the Treasury Department proposals include partial dividend relief, which would mitigate the impact of corporate tax rates on all corporations. See Chapter 7.01.

The current low rates of tax for certain amounts of corporate income permit the use of corporations as tax shelters for individuals. Thus, an individual may attempt to accumulate investment income within a corporation in order to defer tax on the income at the individual's rate. Where the corporate rate is significantly below the individual's marginal rate, the deferral advantage can more than offset the extra burden of the corporate tax. Current law attempts to limit this use of the corporate form through a surtax on the undistributed income of "personal holding companies." The personal holding company rules are complex and not uniformly effective.

The progressive tax structure for corporate income also encourages multiple corporations in order to maximize income taxed at the lowest rates. The current rules limiting this use of the corporate form are again complex and not consistently effective.

Proposal

The present corporate rate structure would be replaced by a flat tax rate for corporations of 33 percent.

Effective Date

The reduction in the maximum corporate tax rate to 33 percent would be effective for taxable years beginning on or after July 1, 1986.

For corporations formed after the date legislation is introduced, the repeal of the graduated corporate rate structure would be effective for taxable years beginning on or after July 1, 1986. For corporations formed on or before such date, the repeal of the graduated rate structure would be phased in. For these corporations, the one-half of the rate increase necessary to raise the lower bracket rates to 33 percent would be implemented for taxable years beginning on or after July 1, 1986, but before January 1, 1987. For taxable years beginning on or after January 1, 1987, all corporations would be subject to the flat rate.

Analysis

Elimination of the graduated corporate rate structure would generally make unnecessary the current provisions concerning domestic personal holding companies and multiple surtax exemptions. Accordingly, those provisions would be repealed to the extent appropriate for taxable years beginning on or after January 1, 1987, when repeal of the graduated corporate rate structure is complete.

REPEAL CORPORATE MINIMUM TAX

General Explanation

Chapter 6.02

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. Corporations with substantial tax preferences are subject to the add-on corporate minimum tax.

In general, the corporate minimum tax (CMT) is equal to 15 percent of the amount by which the taxpayer's items of tax preference exceed the greater of (a) $10,000 or (b) the regular corporate income tax for the taxable year (without regard to the accumulated earnings tax or personal holding company tax, if any, and reduced by most allowable tax credits).

Items of tax preference, in general (some are applicable only to personal holding companies), include:

(a) the excess of accelerated over straight-line depreciation for real property and leased personal property (other than recovery property);

(b) in the case of recovery property other than leased 18-year real property, the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated using under the straight-line method over prescribed (extended) recovery periods;

(c) the tax preference for long-term capital gains;

(d) the excess of amortization deductions for pollution control facilities over the depreciation deductions which would otherwise have been allowable in the absence of special amortization;

(e) in the case of mining exploration and development costs and circulation expenditures, the excess of the amount allowable as a deduction over the amount which would have been allowable had such costs or expenditures been amortized over a ten-year period;

(f) in the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount which would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties;

(g) the excess of a financial institution's deduction for bad debt reserves over the deduction that would have been allowable had the institution maintained its reserves on the basis of actual *experience; and*

(h) the excess of depletion deductions over the basis of the depletable property.

Reasons For Change

The minimum taxes for both individuals and corporations were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

The judgment that a minimum tax is necessary reflects an ambivalence about the desirability and effectiveness of the tax preferences subject to the tax. For example, percentage depletion and accelerated methods of depreciation have traditionally been allowed in part to subsidize the cost of productive depreciable assets and mineral production activities. However, Congress disapproved the consequence that taxpayers receiving the bulk of their income from nonpreferred activities were taxed at relatively higher rates than taxpayers engaged in activities, such as real estate or natural resource production, that benefitted from tax preferences.

The ambivalence in current law toward tax preferences reflects significant doubt about their fairness, efficiency, costs in lost revenue, and consequent effect on marginal tax rates. In general, the Treasury Department proposals accept these doubts as well founded and seek to redesign the income tax base to more closely approximate economic income. If the proposals were fully implemented, the corporate minimum tax would be unnecessary.

To the extent that (1) existing tax preferences (which generally cause a taxpayer's taxable income to be less than economic income) are phased out over an extended period, or (2) taxpayers currently holding tax-favored assets are permitted to retain benefits not available for after-acquired assets, immediate repeal of the corporate minimum taxes would be inappropriate.

Proposal

The corporate minimum tax would be repealed.

Effective Date

The repeal would be effective for taxable years beginning on or after January 1, 1990.

Analysis

Once the corporate tax base is redefined under the proposals to approximate economic income, the need for the corporate minimum tax is eliminated. A by-product of repeal is a slight reduction in the tax-filing burden for the approximately ten thousand corporations who currently pay some minimum tax as well as the computations for most other large corporations which are necessary to determine that they do not, in fact, have any minimum tax liability.